

**COORDINATED ISSUE
PETROLEUM INDUSTRY
ESTIMATED DISMANTLING AND REMOVAL COST**

Issue

Whether an accrual basis taxpayer may deduct estimated cost of dismantling and removing:

1. Offshore platforms
2. Well fixtures
3. Oil and gas pipelines

Background

Accrual basis taxpayers acquire long term mineral leases for the production of oil and gas. Offshore oil and gas leases typically have durations of 20 years or more. Easements are generally negotiated for oil and gas pipeline right-of-ways.

The terms of the leases or land easements contain a contractual obligation to remove the platforms and well fixtures upon abandonment of the wells or termination of the leases. The pipeline must be removed when it is no longer used (i.e., after the last barrel of oil has moved through the pipeline) or upon termination of the easement.

Taxpayers contend that the obligation to remove is fixed and that reasonable estimates of the expense can be made. The future cost estimates may be based on a study conducted on the costs and engineering problems associated with the actual removal.

Position

Section 162 of the Code allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 461(a) provides that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Treasury Regulation 1.461-1(a)(2) provides, in part, that under the accrual method of accounting, an expense is deductible in the taxable year that all of the events have occurred that determine liability and the amount thereof can be determined with reasonable accuracy. An expense is not incurred and, therefore, cannot be deducted

by an accrual method taxpayer until such taxpayer is legally obligated to pay such expense. See Lucas vs. Ox Fiber Brush Co., 281 U.S.115 (1930); Commissioner vs. H. E. Ives Co., 297 F.2d 229 (2nd Cir.1961). Thus, a contingent liability is not deductible by an accrual method taxpayer even if it is virtually certain that the expense will be incurred, because liability is not incurred until occurrence of the conditional future events or facts.

Revenue Ruling 80-182, 1980-2 C.B. 167, sets forth the Service's position with respect to the deductibility of future offshore platforms and well fixture dismantlement costs. The taxpayer involved in the ruling was obligated to remove offshore platforms and fixtures used in its drilling operation when the wells were abandoned or alternatively when certain long-term oil and gas leases were terminated. Although the taxpayer was contractually obligated to remove the platforms and fixtures, Revenue Ruling 80-182, supra, holds that the liability did not become fixed until removal obligations were performed; hence, deductibility of the cost could not precede performance. See National Bread Wrapping Machine Co. vs. Commissioner, 30 T.C. 550 (1958); Spencer, White and Prentis, Inc. vs. Commissioner, 144 F.2d 45 (2nd Cir. 1944), cert. denied, 323 U.S. 780 (1944).

Although the taxpayers are contractually obligated to incur a deductible expense at some time in the future, they have not incurred any liability to pay the costs thereof in the event the future services called for are performed. The liability under the contracts is contingent upon performance. All events are not fixed within the meaning of Treasury Regulations 1.461-1(a)(2) until the required performance is rendered. The fact that the corporations are contractually liable for the cost of the entire dismantlement services does not entitle them to deduct the cost of such services before they are performed.

Since the taxpayer has failed to meet the first requirement of an accrual deduction provided in section 1.461-(a)(2) of the Regulations, it is unnecessary to consider whether the amount of the liability can be determined with reasonable accuracy.